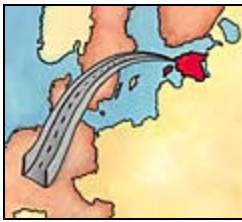




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Estonia Moves Toward EU Accession

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Estonia's rapid transition to a market economy and integration into the world economy have intensified its economic and political ties with Western Europe. It now faces the challenge of meeting the remaining requirements for EU membership and eventual participation in EMU.

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Estonia attaches a high priority to joining the European Union (EU) and participating in European Economic and Monetary Union (EMU). It has therefore moved ahead vigorously with deregulation, price liberalization, enterprise restructuring, and privatization. A large part of its legal framework is already aligned with the frameworks of EU members, and it has undertaken much of the structural adjustment necessary for EU accession.

Estonia's economic integration with the European Union and other European countries is already well advanced. A comprehensive Association Agreement ("Europe Agreement") has been in force since early 1998, and Estonia and the European Union are engaged in a dialogue through an "Accession Partnership." The EU Commission also reports regularly on the progress Estonia and the other accession candidates have made toward meeting the conditions for EU membership set forth in the Copenhagen criteria (see box).

The Copenhagen criteria

At its summit in Copenhagen in 1993, the European Council reached an understanding that all Central and Eastern European countries would be admitted to the European Union once they had fulfilled certain conditions, including adhering to the aims of economic and monetary union. The council established several benchmarks, known as the Copenhagen criteria, for assessing countries' progress toward economic and political compatibility

with the European Union: (1) the existence of stable institutions ensuring democratic government, the rule of law, human rights, and the protection of minorities; (2) the existence of a functioning market economy and the capacity to cope with competitive pressures and market forces within the European Union; and (3) the ability to take on the obligations of membership, including adherence to the aims of political, economic, and monetary union.

Costs and benefits of accession

Countries seeking to join the European Union should find that the long-term gains from membership outweigh the costs. This was certainly the case for Portugal, Spain, and, especially, Ireland, which all experienced rapid growth after becoming EU members. Model-based simulations for EU membership candidates from Central and Eastern Europe indicate that accession will have a similarly positive impact on them. However, one of the challenges faced by accession candidates is that greater integration with the European Union will restrict their scope for autonomous policy choices, given the need for "policy convergence." Estonia's ability to pursue an independent monetary policy is already constrained by its currency board arrangement, which pegs the kroon to the deutsche mark (and thus the euro).

Another challenge is the discipline imposed by the EU benchmarks: before accession, the Copenhagen criteria; after accession, the Maastricht criteria and the Stability and Growth Pact. Compliance with EU regulations and standards entails sizable budgetary outlays and large public sector investments in infrastructure, the environment, and other sectors, and therefore has implications for fiscal policy. For Estonia, which until recently had no import tariffs or other trade restrictions, EU accession also means introducing tariffs and trade barriers that could lead to trade diversion, reduced efficiency, and welfare losses.

Any assessment of the possible costs and benefits of EU accession is subject to methodological caveats and is therefore necessarily subjective. Moreover, many of the domestic policies needed to bring Estonia into compliance with EU criteria have not yet been implemented, and the policy framework of the European Union itself is a "moving target" likely to undergo important changes. These factors make it difficult to determine the precise impact of EU membership—or nonmembership—on Estonia's external trade, financial sector, and fiscal policy.

Trade, financial markets, fiscal policy

Estonia's economy is small and wide open. In 1998, Estonia had the most liberal trade policies of all the transition countries, and much of its trade was already oriented toward the European Union (Table 1). With its open capital account and full currency convertibility, it enjoys easy access to the international capital markets. Since the mid-1990s, Estonia has received large inflows of foreign capital, mostly from other EU countries. Although, among the transition countries, the Czech Republic, Hungary, and Poland received the most foreign direct investment in absolute terms during 1989-98, Estonia was the second largest recipient on a per capita basis (Table 2).

Table 1
Trade indicators for Central and Eastern European countries, 1998

	Exports and imports (percent of GDP)	Trade with EU (percent of total trade)
Albania	42	83
Bulgaria	98	46
Croatia	95	55
Czech Republic	116	60
Estonia	170	70
Hungary	122	70
Latvia	110	55
Lithuania	107	46
Macedonia, former Yugoslav Republic of	103	43
Poland	55	67
Romania	59	58
Slovak Republic	119	49
Slovenia	115	68

Sources: IMF, Direction of Trade Statistics database; and Bank of Estonia.

Table 2
Foreign direct investment in Central and Eastern European countries

	Cumulative inflows 1989-98 (million dollars)	Cumulative inflows per capita 1989-98 (million dollars)	Inflows per capita 1998 (dollars)
Albania	384	103	12
Bulgaria	1,352	163	48
Croatia	2,086	464	190
Czech Republic	8,053	782	120

Estonia	1,467	1,005	387
Hungary	14,508	1,429	94
Latvia	1,645	666	111
Lithuania	1,566	422	249
Macedonia, former Yugoslav Republic of	175	80	25
Poland	14,680	380	159
Romania	4,489	199	90
Slovak Republic	1,331	247	56
Slovenia	1,199	603	83

Sources: IMF, *International Financial Statistics*, and *World Economic Outlook*, various years (Washington: International Monetary Fund).

Trade. In 2000, required to demonstrate its ability to administer the EU's comprehensive trade and tariff regime, Estonia introduced tariffs, mainly on agricultural products, within the limits agreed with the World Trade Organization. However, these tariffs do not apply to imports from the European Union or Estonia's other major trading partners—such as Russia and Ukraine—with which it has concluded free trade agreements. Thus, trade diversion and welfare losses following accession will hinge on the level of trade protection toward non-EU members in effect before EU membership and are likely to be limited.

The impact of EU membership on trade will also depend on whether Estonia is able to increase its access to EU markets, especially those for agricultural products and services, which are generally not subject to the Association Agreement. Whether Estonia can increase its share of these markets will depend on how quickly it adopts and implements relevant EU regulations, which will require, in turn, that Estonia build up the necessary administrative capacity. Equally important is the ability of Estonia's private sector to comply with sanitary and safety standards for products sold within the EU's common market.

EU accession will likely spur domestic competition and structural change, leading to a sustained increase in output capacity and productivity. Estonia's liberal trade regime already makes it fairly easy for foreign firms to operate in the country, but there is scope for increased competition.

Financial markets. Estonia's liberal policy regime has created a favorable investment climate and made it possible for the country to attract foreign investors, particularly in the telecommunications and banking sectors. With increased

access to EU markets and its proximity to Russia and other countries in the Commonwealth of Independent States, Estonia is likely to attract even more foreign capital, technology, and know-how, including in its energy and transport sectors, where major privatization projects are under way. Estonia's adoption of the comprehensive package of EU legislation will make it easier for multinational enterprises to include Estonia in their Europe-wide business strategies.

Compliance with EU regulations on capital movements and financial services and with minimum standards for bank regulation and supervision can be expected to improve financial intermediation and deepen the domestic financial sector. Free market access for providers of financial services is bound to spur securities trading, increase portfolio flows, and render the stock market more liquid. In addition, borrowing from foreign banks and launching equity issues abroad should become easier and less costly for large and medium-sized Estonian enterprises.

Transfer payments to and from the European Union—grants and loans as inflows and contributions to the European Union as outflows—can be expected to have a direct impact on economic activity in Estonia. Pre-accession financing for infrastructure and environmental projects, agriculture, and technical assistance and training through the PHARE program (the main EU vehicle for technical and financial cooperation with countries in Central and Eastern Europe) and other channels has been set aside for all membership candidates and will be available up to 2006 or the date a country becomes an EU member. From the date of membership, regular EU support mechanisms will apply, while PHARE funding will cease. Estonia can also expect to receive transfers to facilitate implementation of the EU's Common Agricultural Policy. According to IMF estimates, total net transfer receipts for Estonia could average about 2 percent of GDP a year over the medium term following accession.

EU membership is likely to influence creditors' perception of sovereign and currency risk, thereby reducing the risk premium on domestic interest rates. Lower capital costs should increase both the supply of, and the demand for, credit, spurring domestic investment and supporting growth. In the run-up to eventual EMU participation, this effect should become even more pronounced. When Estonia adopts the euro, interest rates will likely decline (fully for short maturities

and partially for longer maturities) to converge with the lower rates in the euro area.

Fiscal policy. On the revenue side, accession will make further tax harmonization necessary for Estonia, which now has a relatively simple, transparent, and efficient tax system (for example, a flat income tax rate of 26 percent). (See also Table 3.) Estonia is unlikely to suffer tax revenue losses owing to the emigration of enterprises or workers; in fact, tax revenues may increase because of stronger real GDP growth, higher excise tax rates, customs tariffs, and a new property tax.

Table 3
Fiscal and convergence indicators of selected EU accession candidates, 1998

	Maastricht fiscal indicators		GDP per capita		
	Government balance	Government debt	Percent of euro-area average	Percent of poorest euro-area country (Portugal)	
	(percent of GDP)	(percent of GDP)		(dollars)	
Cyprus	-6.5	57.2	11,528	51.9	105.0
Czech Republic	2.1	10.7	5,170	23.3	47.1
Estonia	-0.3	7.4	3,501	15.8	31.9
Hungary	-4.7	60.4	4,712	21.2	42.9
Poland	-3.0	43.4	3,854	17.3	35.1
Slovenia	-1.4	25.1	10,044	45.2	91.5
Euro area	-2.1	73.4	22,220
Reference value	-3.0	60.0

Sources: IMF, *International Financial Statistics*, and *World Economic Outlook*, various years (Washington: International Monetary Fund).

... Indicates not applicable.

Accession is likely to put significant pressure on public expenditures, however, primarily because of the need for increased public sector investment in infrastructure and the environment to comply with EU standards. Moreover, the EU has cofinancing requirements. For example, its Instrument of Structural Policies for Pre-Accession makes financing available for infrastructure and environmental projects, but such financing is normally limited to 75 percent of public spending on a project. Compliance with EU standards and fulfillment of the legal and institutional preconditions for EU membership are also likely to increase recurrent budgetary expenditures. But interest rate changes are unlikely to have any impact on expenditures, given Estonia's small public debt and debt-

servicing burden.

Reconciling growth and external adjustment

Our analysis of the budgetary and financial impact of EU membership suggests that an increase in EU-related public investment expenditures and a decline in the interest rate risk premium will not only spur domestic economic activity but also increase Estonia's demand for imports and dependence on foreign financing. Thus, more external financing and gradual interest rate convergence to euro-area levels could widen the current account deficit both directly, through increased imports of consumer goods and investment products related to EU credits, and indirectly, through increases in GDP and import demand.

The potential trade-off between higher growth and external sector imbalances can be demonstrated by our simulations, which are based on the following scenario: (1) an increase in public expenditure of up to 2 percent of GDP over three years, reflecting EU-related spending and cofinancing of infrastructure and environmental projects, facilitated by the availability of significant EU transfers, and (2) a decline of 100 basis points in long-term interest rates within four years of accession. The simulations show that these two shocks, in combination, would trigger an increase in real GDP through rising consumption and investment. In the short-to-medium term, domestic demand, supported by increased public spending, would expand rapidly, putting upward pressure on wages and prices for nontradable goods and services. As the inflation differential with the euro area widens, the real value of the kroon should appreciate. An increase in investment, fueled by lower capital costs, would boost demand even as domestic output capacity grows. The simulation results also show that the current account deficit could widen somewhat after the onset of the shocks in parallel with an increase in real GDP.

Such results are plausible, considering Estonia's experience in 1997 and early 1998 during a period of economic overheating, but they are strongly dependent on the model's assumptions about the time horizon and the consumption and saving behavior of households following the decline in interest rates. In addition, the model-based findings do not capture the entire economic dimension of the EU accession process, including possible changes in policy in response to economic developments. Nevertheless, they strengthen the

case for addressing, head-on and early, possible macroeconomic stress that may accompany accession.

Outlook and policy agenda

Membership in the European Union and adoption of the euro will have important implications for Estonia's macroeconomic policies and performance. Estonia is well placed to benefit through trade and financial and fiscal channels from further formal integration with Europe. The expected reduction in the interest rate risk premium and closer links to Western European financial markets are likely to improve access to financing on more favorable terms. On the fiscal side, there are gains to be reaped from significant transfer payments, which will provide non-debt-creating financing and alleviate budgetary pressures.

Notwithstanding the favorable overall perspective, the accession process gives rise to important macroeconomic policy challenges. Additional expenditures necessitated by required investments in the environment and infrastructure sectors could result in a notable increase in the share of public expenditure to GDP. To the extent that domestic demand expands as a result, spurring imports of consumer products and project-related investment, Estonia's current account position could be adversely affected. Lower interest rates, which tend to boost domestic investment, could compound an eventual widening of the external imbalance. However, this outcome is not predetermined because the supply-side response of the economy could be quicker and stronger than anticipated. Most notably, the net effect of EU membership on the balance of payments will depend on private saving behavior and Estonia's fiscal policy stance.

The limited number of macroeconomic policy instruments available for responding to such developments calls for a determined fiscal and structural policy agenda. Because of its currency board, Estonia cannot respond to shocks by revaluing its currency, and adjustment will therefore occur largely through the real economy, via changes in domestic prices, wages, and employment. Policies that dampen domestic demand and promote household saving will be needed to help improve Estonia's external position. Estonia would be well advised to continue pursuing prudent fiscal policies with the objective of containing the demand effects of the expected increase in government spending as a result of EU accession. Also, the efficient use of funds for public

investment will be critical. Other policy priorities should include maintaining a flexible labor market and fostering competition in the domestic goods markets; finalizing pension reform; making further adjustments to, and ultimately liberalizing, prices that are still administered; and ensuring sound and efficient financial intermediation by further improving financial sector supervision.

This article is based on René Weber and Günther Taube, 1999, "On the Fast Track to EU Accession: Macroeconomic Effects and Policy Challenges for Estonia," IMF Working Paper 99/156 (Washington: International Monetary Fund).

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